Distribution Agreements: A Lawyer’s Perspective

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Central Themes

- Typical clauses under distribution contexts
- Protection of distributor from inherited non-compliance issues
  - Problems with broad distributor compliance obligations
  - Examples under specific substance and product laws (biocides, REACH, food)
- Competition law issues under distribution contracts
- Dispute resolution
  - Arbitration
  - Significance of governing law and jurisdiction
Typical Clauses in a Distribution Agreement (I)

- **Exclusive distribution**: distributor exclusive outlet in defined territory?
  - also exclusive sourcing (distributor to buy brand directly from supplier only)?
  - also exclusive customer allocation (distributor to sell to pre-defined customer group only)?

- **Selective distribution**: relevant to FECC distributors (normally final branded products – luxury, technical goods)?
  - distributors selected on meeting product related criteria, e.g. trained staff, sales premises requirements (not territory)
  - control of resale environment by restriction of resales to end users and other appointed distributors only

- **Definition of ‘Territory’** (what type of sales outside of territory are prohibited?)

- **T&Cs of buyer order** *(minimum purchase/annual quotas)* and distributor pricing *(minimum or recommended pricing)*

- **Shipping/delivery** (passing of risk, deadlines, who bears costs)
Typical Clauses in a Distribution Agreement (II)

- Distributor obligations to check deliveries, report quality issues, return of substandard goods (GMP/quality standards)
- Cooperation on marketing materials, obligation on distributor to promote/advertise?
- Permission (exclusive/non-exclusive) to rely on Supplier’s IP as necessary to market goods
- Vendor warranties/guarantees on EU regulatory compliance of goods?
- Liabilities and indemnification
- Confidentiality (proprietary/commercially sensitive information received by distributor)
- Choice of governing law for interpretation of contract and related disputes
Typical Clauses in a Distribution Agreement (III)

- Choice of jurisdiction (which courts?)
- General compliance with laws clause:
  - parties to carry out their obligations under the Agreement in accordance with all applicable laws (competition, data protection)
  - nothing in this Agreement shall be construed as permitting a breach of …
- Termination
- Other generic clauses (entire agreement, amendment procedures, force majeure, etc.)
Liabilities for Regulatory Non-Compliance: Distributor Protection?

- To what extent can liabilities be limited (e.g. clause limiting liability of supplier to death or personal injury?)
  - choice of governing law may limit ability to restrict liability: for example, cap on damages? exclusion of recovery of consequential losses?
  - Limitation of liability towards non-parties!

- Extent to which each party be liable for damages payable/ loss of profits caused by actions of other?

- Is distributor sufficiently protected in case of its EU sales liabilities arising from upstream regulatory non-compliance (‘inherited’ liability)?
  - fines, damages, loss of profits, attendant legal costs
  - regulatory enforcement and related third party actions and/or related business interruption (downstream customer contract)

- Protection:
  - supplier EU regulatory compliance guarantees
  - indemnities from supplier (cover distributors customer claims too?)
Issues with Distributor Compliance Clauses

- Generic compliance obligation: ‘Distributor will, at its expense, obtain and maintain registrations and filings that may be required under the laws of the Territory to execute or perform this Agreement and otherwise apply with all laws, regulations or other requirements’ – potential issues:
  - does relevant legislation permit the distributor to meet specific obligations (reserved for other supply chain actors)?
  - **NB** substance/product substitution mechanisms under REACH, biocides, food additives threaten continued ability to sell – ability for distributor to proactively defend substance/product under formal procedures?
  - need for significant input (information, other assistance) from supplier to comply? (appropriate clauses)
  - reasonable for distributor to cover *all* compliance costs?
Regulatory Compliance Issues: Example of Biocidal Products

- Biocidal Products: insecticides, preservatives, disinfectants, anti-foulants, antibacterial paints, wood preservatives

- Common active substances: (sodium hypochlorite in bleaches, ethanol for hand wipes, copper for antifoulants, etc.)

- New obligations key to continued EU sales (Regulation 528/2012):
  - EU sales post 1 September 2015 conditional on inclusion of suppliers of active substances and biocidal products in approved list
  - new products subject to active substance approval or product authorisation requirements for first time:
    - imported treated articles (substance, mixture or article treated with biocide – for example, treated wood, fungi resistant paints, mould-proof sealant, building materials preservatives)

- Does contract specify who is responsible – supplier or distributor?
  - if distributor responsible (as importer placing on market (for first time) or supplying a biocidal product), needs dossier or letter of access – supplier to provide?
Regulatory Compliance Issues: Example of REACH

- Distributor not responsible for registration unless ‘importer’ under REACH (rather upstream importer, EU manufacturer or Only Representative) BUT …

- Distributor **liable** for placing on market unregistered substance (on own, in a mixture or in certain finished products)

- Importance of supplier contractual guarantee of REACH compliance (registration, SVHCs, (SDSs, authorisations?))

- If distributor is (importer) registrant, who responsible for ECHA fees, individual dossier preparation, purchase of LoA and SIEF/consortium costs?
Regulatory Compliance Issues: Example of Food

- Regulation 178/2002 (Article 17(1)): ‘Food and feed business operators at all stages of production, processing and distribution within the businesses under their control shall ensure that foods and feeds satisfy the requirements of food law which are relevant to their activities and shall verify that such requirements are met.’

- Case 315/05 (*Lidl Italia*):
  - MS national laws *can* impose liability on distributors for non-compliant food product labeling (of upstream manufacturer)
  - not limited to traceability, etc.
  - wide (over expansive?) view of distributor’s compliance obligations (‘relevant to [distributor’s] activities’)?
  - Court ignore defence that: ‘The distributor cannot know whether or not the label affixed to the packaging by the producer contains true information’.
Why Competition Law Compliance is Important?

- Whether infringement deliberate or inadvertent:
  - lengthy investigations
  - massive fines
  - void and unenforceable agreements or clauses (potentially supplier and distributor liable)
  - private ‘follow on’ actions for damages in national courts
  - criminal sanctions in some jurisdictions (for example, UK Enterprise Act 2002 – imprisonment of leaders)
  - reputational damage

- Investigations initiated by complaint of distributor or supplier’s competitor

- Typical scenario: distributor avoids compliance with contractual obligation by arguing that anti-competitive (unenforceable)
Distribution Contracts: Factors Determining what T&Cs are Deemed Anti-Competitive

- **Type of Distribution Agreement:**
  - distribution agreement between non-competitors: most common
    - assessed under ‘vertical restraints’ regime
  - commercialisation (distribution) agreements between competitors:
    - assessed under horizontal cooperation regime (price fixing, market partitioning, exchange of commercial info, output limitation), except in limited circumstances

- **Market Share:** as market share increases so does ability to restrict competition on the market
### Distribution Contracts: Market Share Implications re Competition Compliance

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<tr>
<th>0%</th>
<th>10%</th>
<th>15%</th>
<th>30%</th>
<th>80%</th>
<th>100%</th>
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<tr>
<td>De minimis where competitors (no issue, except hardcore restrictions)</td>
<td>De minimis where non-competitors (no issue, except hardcore restrictions)</td>
<td>Block exempted (except hardcore or excluded restrictions)</td>
<td>Effects Analysis (competition restrictions outweighed by efficiencies/consumer benefits)?</td>
<td>Dominance (economic strength means can prevent effective competition by behaving independently of its competitors, customers and consumers) = ‘special responsibility’ not to allow its conduct to impair competition, e.g. refusal to supply, discriminatory pricing, loyalty rebates (Article 102 TFEU)</td>
<td>Super dominance / monopoly</td>
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De minimis

- Where the share held by the dominant undertaking is below threshold levels of de minimis, there is no direct infringement of the prohibition on restrictive practices.

- However, where the relevant conduct is hardcore or excluded restrictions, there is an indirect breach of the prohibition on restrictive practices.

- The existence of a hardcore restriction means that the undertaking is dominant and the relevant conduct is illegal per se.

Dominance

- Economic strength means can prevent effective competition by behaving independently of its competitors, customers and consumers.

- Dominant undertaking has special responsibility not to allow its conduct to impair competition, e.g. refusal to supply, discriminatory pricing, loyalty rebates (Article 102 TFEU).

Super dominance / monopoly

- When a dominant undertaking is subject to heightened scrutiny as it may have substantial monopoly power.

- The undertaking must ensure that its conduct does not impair competition, taking into account the efficiencies and consumer benefits that it may bring.

- The undertaking may be subject to specific measures to mitigate the anti-competitive effects of its conduct, such as commitments or sanctions.
Competition Issues re Distribution Agreements between Non-Competitors (I)

- ‘Vertical agreement’ between 2 or more undertakings operating at different levels of the production or distribution chain

- Agreement restricting competition (Article 101 TFEU)?

- Block exemption ‘safe harbour’ up to 30% of supplier’s and buyer’s market shares for the goods: presumption that restrictive effects outweighed by overriding efficiencies (‘a reduction in the transaction and distribution costs of the parties…’)

- …Provided that they do not contain ‘hardcore restrictions’ of competition (whole agreement void and unenforceable):
  - resale price maintenance: express or de facto – price recommendation, plus pressure (threatened termination or increase supply prices) or incentive
Competition Issues re Distribution Agreements between Non-Competitors (II)

- restrictions on customer resales to territories or customer groups (market partitioning), except in specific circumstances
  - restriction on active sales (but not passive (unsolicited) sales) into territory or customer group already exclusively reserved to supplier or another customer
  - restriction on wholesalers selling to end users (undermining investment by retailers in promotion and retail premises)
  - restriction of buyer’s distribution outlets or warehouses to a particular address, place or defined territory.

- Internet/email sales:
  - general prohibition not permitted
  - can prevent specific (active) targeting of customers in exclusively reserved customer group and territory
  - may insist that distributors have one or more physical (‘brick and mortar’) sales locations to prevent them selling exclusively online
Competition Issues re Distribution Agreements between Non-Competitors (III)

- **Excluded restrictions (only clause itself void, if severable)** – subject to certain exceptions:
  - non-compete (‘single branding’) obligations on buyer beyond a certain duration (not to purchase, manufacture etc. goods competing with contract goods or to purchase from supplier more than 80% of its total needs)
  - quantity forcing ‘annual purchase quotas’ accompanied by supplier option to terminate if not met

- Obligation on buyer not to manufacture, purchase or sell post termination

- Direct or indirect

- Outline safe harbour – effects analysis (overriding consumer benefits)?
  - same rules applied or stricter
Dispute Resolution (I)

- “… shall make all reasonable efforts to settle amicably…”

- Choice of governing law and jurisdiction (which courts?/dispute ‘forum’):
  - express choice of jurisdiction: legal certainty (avoid complex/costly conflict of laws analysis)
  - ..but (EU Rome I Regulation) freedom of choice circumscribed: governing law not upheld where would circumvent mandatory public policy laws of country closely connected with contract
  - not expressed, then default ‘closest connection’ concept:
    - normally country of habitual residence of carrier of goods, or of place of delivery (law); or
    - where defendant domiciled or where goods delivered (courts)

- Choice of governing law may:
  - determine criteria for an arbitration clause and/or arbitration award to be enforceable? and
  - prohibit use of arbitration in certain circumstances (for example, disputes below a certain value threshold)?
Dispute Resolution (II)

– determine what is ‘reasonable notice period’ for termination (for example, German ‘sliding scale’ depending on duration of contract to date – i.e. 1 month notice for 1 year, 2 month notice for 2 years, etc.)

– method of execution of contract

▪ Choice of jurisdiction:
  – ability to enforce judgment in territories outside those of forum?
    • where are defendant’s assets (English judgment enforceable against defendant’s assets in South Africa?)?
    • existence of reciprocal enforcement treaties (for example, none between US and UK)

▪ Arbitration
  – avoid disputes going to national courts with attendant publicity?
  – fairer to both parties? - more flexibility to have governing law different from forum, choose applicable language and/or law not necessarily that of location
  – under which arbitration rules? how many arbitrators? place of arbitration? language of arbitration?
Take Home Messages

- **Regulatory compliance obligations:**
  - more specific and nuanced distributor compliance clauses needed (responsibility for ‘all applicable laws’ may be unworkable)
    - distributor may not be correct supply chain actor to meet substance or product obligations
  - liability not limited to issues within distributor’s control?
    - importance of guarding against ‘inherited’ liability issues through supplier compliance guarantee and indemnities (food, REACH, biocides)

- **Competition considerations:**
  - covered by safe harbour?
  - existence of hardcore (resale restrictions - price maintenance, territory or customer group) or excluded (non-compete) restrictions

- **Dispute resolution:**
  - express choice of governing law and dispute forum (courts) important
  - governing law may restrict parties freedom of contract (for example, ability to arbitrate or terminate)
  - consider enforceability when choosing forum
  - arbitration attractive for flexibility and because out of public glare
Steptoe Life Sciences and Antitrust Practices

- Questions?

- For additional information about our services, please contact csimpson@steptoe.com or jnmaillard@steptoe.com or visit our website:
